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FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC PRIORITY 0610
INFO RUCNCIS/CIS COLLECTIVE PRIORITY
RUEHXD/MOSCOW POLITICAL COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RHEHNSC/NSC WASHDC PRIORITY

C O N F I D E N T I A L MOSCOW 003222

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E.O. 12958: DECL: 11/03/2018
TAGS: ECON EFIN RS
SUBJECT: FIRST DEPUTY PM SHUVALOV ON G-20 SUMMIT, CRISIS
RESPONSE MEASURES, AND WTO

Classified By: Ambassador John Beyrle for reasons 1.4 (b,d)

Summary

¶1. (C) In an October 30 meeting with the Ambassador, First Deputy Prime Minister Shuvalov outlined Russia's general positions on the G-20 Summit: coordination of currency policy; opposition in principle to protectionism; and improving the quality of existing government regulatory mechanisms without expanding the role of the state in the economy. Shuvalov warned against what he viewed as tendencies in global crisis response, particularly in the U.S., to over-regulate the economy. The Central bank would support the current ruble exchange rate as long as possible and resist devaluation. Falling oil and gas revenues and the possibility of a budget deficit were causing concern, but Shuvalov insisted the government was prepared to "burn through its reserves" to support the corporate and banking sectors during the crisis. On WTO, Shuvalov asked for U.S. intervention to resolve bilateral issues with Georgia and Ukraine. The Ambassador reiterated U.S. support for Russia's WTO accession, but emphasized that the Russian government must adhere to its commitments and rein in protectionist elements. End Summary.

Proposals for the G-20 Summit

¶2. (C) In a candid, hour-long exchange with the Ambassador, Deputy Prime Minister Igor Shuvalov (PM Putin's second in command) outlined Russia's goals for the upcoming G-20 Summit in Washington. Although he made clear President Medvedev's chief economic aide, Arkadiy Dvorkovich, would be drafting the specific proposals, Shuvalov was willing to discuss their general content (suggesting that Putin's input would be considerable).

¶3. (C) First of all, Shuvalov said, there had to be a general understanding that all G-20 countries would coordinate their actions, and that no steps taken by one member would be to the detriment of another. For example, Russian efforts to support the ruble must not have a negative impact on the dollar. Reform of international financial institutions must be coordinated with the goal of stimulating world economic growth. The Russians were particularly uneasy about the projected economic slowdown in the Euro zone (much more vulnerable to global crisis than the U.S., in Shuvalov's view), but took some comfort in that the fact that European

economies proved able to absorb the impact of escalating oil and gas prices over the past decade. As for Russia, Shuvalov said the worst of the crisis had passed "like a bad fever" and that the economy would be on the road to recovery by the middle of next year. However, he cautioned, Russia's recovery depended on growth rates globally.

¶4. (C) In principle, the Russians opposed protectionism and barriers to free global trade. However, short-term trade distorting measures should be permitted on a case-by-case basis to help certain vulnerable sectors and industries deal with the effects of the crisis. At the same time, concerns from some quarters of the G-20 (i.e., Washington) that Russia was lapsing into protectionism or "closing its markets" were unfounded.

¶5. (C) The Russian government viewed excessive government intervention in the economy as a danger to growth and development. The G-20 should therefore focus on improving the quality of existing government regulatory mechanisms and avoid tendencies to expand the role of government "management and regulation" of national economies. Shuvalov expressed concern that even in the U.S., where liberal market mechanisms were firmly rooted, emergency measures atypical of a market economy were being implemented: "we get worried when we see the U.S.doing this." He stated that the emphasis in Russia would be on preserving private enterprise, and dismissed media speculation that government intervention could lead to a broad redistribution of property or the imposition of state management on the companies it bailed out.

Domestic Corporate and Financial Bailout

¶6. (C) Shuvalov described the government's latest actions to address the financial crisis. Russia was using $50 billion of its reserves to help major corporations (the "locomotives" of the Russian economy) redeem their foreign debt. The first beneficiary was Oleg Deripaska's "Rusal", which had secured a $4.5 billion loan (to purchase Norilsk Nickel). The Central Bank transferred the cash to the state-owned Vneshekonombank (the Development Bank), which, in turn, imposed strict conditionalities: Rusal must pay back the loan by 2010 or transfer its shares to the state. (Shuvalov said Deripaska initially resisted that conditionality.) Similarly, all companies that were converting their foreign debt to domestic debt would be obliged to pay back the state on terms often more stringent than they would receive from Western financial institutions. The government would take preferred stock from recipient companies as collateral. If the value of the preferred shares fell, the government would act as any other private lender and exercise margin calls. However, Shuvalov emphasized, refinancing for the companies was an option, not an obligation.

¶7. (C) Refinancing of the banking sector was taking place through auctions of repo loans and "lombard" loans (collateralized loans). Interbank lending rates were as high as 16 percent; but were relatively low in real terms given the present rate of inflation (14 percent). The biggest problem in the banking sector was lack of trust. There was widespread concern that small and medium sized banks would fold, leading people to withdraw their savings from the smaller private banks, often converting them into dollars. Shuvalov blamed the media for exaggerating the extent of the crisis in Russia and causing a capital flight from private and state banks. In reality, he said, the Deposit Insurance Agency (ISV) guaranteed deposits of up to 700,000 rubles (approx 28,000 USD). Furthermore, the largest state savings bank (Sberbank) had been accumulating dollars for months in anticipation of the increased demand: "Gref is flying them in by the planeload," Shuvalov joked, to ensure ATMs are well stocked. Nevertheless, he acknowledged, many small and medium sized banks would eventually fold, beginning within the next several weeks. Consolidation of the banking sector

was to be expected; the optimal number of banks was about 450, or about half the current size.

Supporting the Ruble

¶8. (C) Shuvalov said the Central Bank would support the current exchange rate of the ruble "as long as possible". The government would continue to counter rumors of denomination or devaluation. The Central Bank had spent billions of dollars weekly to defend the ruble. In order to deter speculation against the ruble, the Central Bank introduced daily limits on currency swap operations. The Central Bank would stop refinancing facilities to those banks that merely continue switching to dollars. It would monitor recipient banks and make decisions on granting them collateral-free loans based on proof they would release those funds into the Russian economy rather than keeping them in foreign exchange.

Burning Up the Reserves

¶9. (C) Meanwhile, as oil and gas prices continued to fall, the government was concerned about the budget surplus turning into a deficit. Although reserves had fallen below $500 billion, they were sufficient to guarantee macroeconomic stability: i.e., cover the costs of supporting the ruble and refinancing banks and corporations. Other investments (e.g., infrastructure, public-private partnerships) might have to be postponed. Shuvalov stated that the government was prepared to "burn the reserves" to get out of the present crisis. After all, the reserves were meant for a "rainy day" and that day has come, he declared. He recalled his internal arguments against those who wanted to tap the reserves for budget needs like road repair or pension support. Now they would see that that the purpose of the reserves was to jump start the ailing banking and corporate sectors.

¶10. (C) The "bright side" of the crisis, Shuvalov mused, was that Russians were now beginning to understand the real value of money. When oil and gas revenues were at their peak, windfall profits bred inflation and corruption. The ruble was overvalued by as much as 60 percent. Now, people would begin to heed Finance Minister's Kudrin's warnings about fiscal profligacy and accumulation of large debts. Perhaps, the crisis would be an opportunity for the government to push for some of the reforms President Medvedev announced at Krasnoyarsk in February - or even enact energy conservation measures.

WTO Accession

¶11. (C) The Ambassador emphasized that the U.S. supported Russia's WTO accession and that, contrary to allegations of some Russian officials (including Shuvalov), Washington was not urging U.S. companies to stop doing business in Russia. A new U.S. administration would review the WTO issue in terms of what Russia had done so far to meet its commitments. Moves by the Veterinary Service and Agricultural Ministry to walk away from side letters and commitments to the U.S. were unhelpful. The Russian government had to rein in the Veterinary Service and other protectionist elements if it was serious about U.S. support. Shuvalov asked that the U.S. intervene with Ukraine and Georgia to help resolve outstanding bilateral WTO issues with Russia. He commented that U.S. allies (Australia, Canada) followed the U.S. lead in WTO and apparently added new conditions on Russia for "political reasons" following the Georgia conflict. The Ambassador pushed back, stressing that the WTO was consensus-based body focused on trade not politics.

Comment

¶12. (C) Shuvalov was candid and forthcoming about Russia's reserve problems and the pressures on the ruble exchange rate. He also echoed recent statements by Prime Minster Putin to the effect that Russia was not turning to protectionism or seeking to restore the primacy of the state sector. The position Shuvalov outlined for the G-20 summit was basically consistent with the principles of global free trade and reform rather than replacement of the existing international financial system. On the domestic front, Shuvlaov expressed a degree of confidence (lacking over the previous weeks) that the worst of the crisis had passed. This may have had something to do with the moderate recovery in Russian and global markets over the past week. End Comment.

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